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Rural finance and the role of development banks: Recent experience in South Africa

by

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Abstract – In the quest to expand access to financial services in rural areas the agricultural development bank is re-examined. Four issues that need to be addressed in the restructuring of these institutions are discussed, viz. the arguments for intervention, the rules that need to be applied in the context of the new approach to development finance, the management of the restructuring process and the politics of change. These issues or rules are applied to the restructuring process of retail development banks at the provincial level in South Africa. It is illustrated that for successful transformation political will and a shared vision are also necessities. The impact of appropriate transformation is quantitatively illustrated by the impact on financial self-sustainability in one such bank when these aspects have been adequately addressed in the transformation process and the failure in the remaining institutions when they are not.

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Introduction

Today the institutional profile of development finance at the retail level is wide and varied and far different from the mono-institutional culture from the 1950s to 1980s. The result in terms of clients obtaining access to financial markets is remarkable. Since the 1970s it is also an urban story. Nevertheless access to financial services in rural areas of developing countries continue to be a vexing problem and the debate still continues on what would be the best institutional format for improving access. During this debate the market failure "interventionist" lobby also spoke out frequently.

In this paper we turn to these debates on a country specific basis. After providing an overview of the discussion on whether intervention is justified we provide a general overview of the history of agricultural development banks and then relate experience and lessons to the recent restructuring of development banks in South Africa. We base our discussion on the experience in three provinces in South Africa, covering four development banks. The aim of this paper is to highlight issues and lessons learned.

The arguments around intervention or beyond market and the state

Government intervention is typically defended to provide public goods (health, nutrition, mass vaccinations, education, etc.) since without this intervention supply would be less than optimal. This is due to the inability of private agents or suppliers of these services to internalise the positive externalities to society at large generated by the supply of these goods and services. These services have been characteristically supplied directly by government through traditional channels of Public Finance (i.e. government expenditures). However, more recently in some developed countries outsourcing and voucher movements have emerged challenging the government's continued supply of these services.

Development Finance, on the other hand, is not designed to supply public goods. On the contrary, as the name implies development finance institutions (DFIs) supply loans or equity finance to, inter alia, private businesses, individuals and local authorities. The contrast to public finance is clear. DFIs expect to be repaid. The question arises why can't private lenders make these loans? What justification is there for the government to intervene in private markets to either provide these services or subsidise their supply by others? Four arguments are frequently made to justify the intervention of government in financial markets: (i) monopoly; (ii) externalities; (iii) imperfect information; and (iv) contract enforcement problems (Besley, 1992).

[1] By .....The usual disclaimers apply.

Most researchers of market failure invariably end their statements for government intervention by recommending once again, the tried and tested policies of government failure in the past, i.e. government credit programs, targeted credit, and subsidised interest rates. This is done despite the fact that the financial landscape of developing countries is littered with the carcasses of dead and half-dead government, targeted lending programs with subsidised interest rates. None of these traditional recommendations get to the "core" of the problem, i.e. the causes of information deficiencies and/or contract enforcement problems.

Intermediation in rural areas

Financial intermediation for banks and clients is more difficult and costly in rural than in urban areas because of three inescapable rural characteristics, viz. spatial dispersion and the associated high information and transaction costs; specialisation of rural areas in a few economic activities linked directly or indirectly to agriculture, which exposes rural clients to the vagaries of nature and leads to covariance of their incomes; and seasonality of production with its accompanying sharp and opposite fluctuations in the demand for credit and deposit services (Coetzee, 1997).

Specialised farm credit institutions, the mechanisms of the conventional supply-led approach to rural credit, are poorly adapted to the difficulties associated with rural finance. They typically do not diversify their client base and portfolio within rural areas. They usually are not integrated into larger institutions with urban operations and have limited urban diversification and risk pooling opportunities. Even with inter-regional risk pooling they remain vulnerable to major droughts affecting an entire country or to international commodity price slumps.

Agricultural development banks

"Why are specialised farm credit institutions established in low-income countries, and why do they frequently flounder?" were questions posed by Von Pischke (1978). These institutions have often been used by states as conduits for carrying out agricultural and social policies, such as compensating the farm sector for excessive taxation of agriculture and urban bias. This has led to a lack of an autonomous governance structure. It is this lack of autonomy that has crippled these institutions rather than state ownership *per se*. Because government has pursued social and agricultural policy objectives *via* rural financial institutions, these institutions have been particularly vulnerable to collusion by their politically organised clients. Using specialised financial institutions to compensate farm sectors or pursue social objectives has mostly been futile. All the participants in the agricultural sector suffer from bad policies, bad prices and/or bad weather, however only a minority of better off clients have access to credit and therefore received "compensation". Supply-led subsidised credit invariably worsened wealth and income distribution.

This experience induced a re-examination of rural financial markets. The market was rediscovered and these institutions, being supply-led in nature, obviously did not meet the requirements of the new approach to rural finance. In the drive towards the market specialised credit institutions were sidelined. Recently, the realisation dawned that in countries with a weak private financial sector these were the only institutions providing services in rural areas, albeit within a distorted and skewed policy framework. Even where the private commercial banks have a prominent presence, it still is not willing to provide financial services on a broad basis in rural areas. An example is South Africa where the number of people in close proximity to a commercial bank branch declined from 52% in 1995 to 34% in 1998 (Eskom, 1998). This trend is continuing and the reasons for this in South Africa are relatively low profits in the retail finance market and the high cost of providing branch-based services in rural areas. The amalgamation of commercial banks in South Africa also contributed to the decline in the number of branches due to rationalisation. Over the last three years nearly 10% of commercial bank branches were closed. Attention is now shifting back to development banks as one institutional form within a range of retail outlets to increase outreach in rural areas. However it is not yet clear whether this refocus is noticed or supported by the large multilateral development finance institutions. Furthermore, development banks in their conventional guise would obviously offer no answers. Emphasis is placed on the restructuring of these institutions with the objective of emulating commercial operations with a development facet, thus taking up the challenge of being self-sustainable and having a development impact and broad outreach at the same time, a formidable challenge. However, some international examples of successful restructuring do exist, of which Bank Rakyat Indonesia (Yaron, 1992) is a prime example. Based on these experiences restructuring and transformation should adhere to certain guidelines such as clarifying an "arms length" role for government, ensuring autonomy of the institution and entrenching good governance practices, minimising systemic and institutional risk, mobilising financial resources through *inter alia* savings mobilisation, adequate one off capitalisation, cost covering pricing policies, emphasis on high quality personnel, decentralisation and staff and client incentive schemes allied to innovative micro and small enterprise lending technologies pioneered by best practice micro finance organisations, transparent measurement of performance, co-ordination with other development efforts and caution and limited use of external donor support.

If a transformed institution performed well, it could offer through its extensive rural branch network a range of valuable deposit and savings services for the poor far better than NGO programmes. Moreover portfolio diversification and extensive branching would alleviate the covariant risk associated with site specific unit banks or limited reach NGOs.

Experience in South Africa

In the recent transformation of South Africa the transformation of its development finance system did not receive priority attention. Specific institutions were transformed in piece-meal fashion and the rest of the development finance sector had to take its cue from the implied policy of government emanating from restructuring of national level institutions. The process at the provincial level (retail level) was unstructured and transformation approaches were not standardised between provinces. This led to a range of development finance institutional formats. In some provinces functions were pooled in one institution and these provide a so-called one-stop service. Other institutions were closed. The end result was that of the more than 150 parastatal institutions in the country in 1990 very few survived the ongoing political and institutional changes. The reasons mostly focus around the abolishment of the homeland system in the country with the demise of apartheid and gross inefficiencies highlighted by a formal study commissioned by the government in 1996 (the Strauss Commission).

Agricultural development banks escaped this ad hoc approach to transformation. The Strauss Commission study preceeds the restructuring of the provincial development banks. This study investigated access to financial services for rural people and concluded that all institutions providing retail financial services in rural areas suffer from extremely high costs or limited outreach, or both. This includes commercial banks, NGOs and development banks.

Shortly after the Strauss Commission reported the four development banks servicing rural areas were submitted to restructuring studies and strategies. These were the Ithala Development Finance Corporation Limited (Ithala) in the KwaZulu-Natal province, the Agricultural Bank of North West Province (Agribank), the Ciskeian Agricultural Bank (CAB) and the Agricultural Bank of Transkei (ABT), both from the Eastern Cape Province. In the rest of this paper it will be shown that specific differences in the restructuring processes resulted in specific outcomes. Note that the restructuring processes are not complete and that we are highlighting preliminary lessons. The Strauss Commission evaluated the four institutions under discussion in detail in 1995. Most of these institutions suffered from high subsidy dependence and low outreach

The restructuring process

Several issues are at stake in the restructuring process of development banks. Firstly, is the argument whether a specific institution should continue to exist, thus an economic justification is needed for its existence. Where the institution is highly successful the argument can be made that it may be crowding out the private sector. Where it is quite inefficient it can be argued that it is costing the state more than the benefits flowing from its operations. This is the first issue on the way to restructuring.

The second issue of importance is the guidelines or framework for restructuring. This refers to the emphasis of the new approach to development finance where institutions should simultaneously strive to be self-sustainable and have broad outreach. In this regard the issues concentrate on governance, ownership, autonomy and incentive-based systems. These guidelines would ensure that most of the negative elements of the conventional approach will not be present in a restructured institution. Of paramount importance are the governance structure, the selection of the governing board and incorporation of governance rules. This emphasis echoes international trends in the corporate sector where governance is regarded as an important aspect of organisation design and where board members of institutions have increased responsibilities. These aspects are steeped with principal agent problems, i.e., the cost of enforcement and monitoring of contracts.

The third important issue has to do with the management of transformation and restructuring. Even where governance and other rules have been adhered to the way this process is managed and supported will determine success or failure. It is argued that most transformation efforts fail due to the inability to manage this process of transformation. Eight steps are proposed that should be followed (see table 1).

Table 1: Eight steps to transforming an organisation

Step 1	Establishing a sense of urgency
Step 2	Forming a powerful guiding coalition
Step 3	Creating a vision
Step 4	Communicating that vision
Step 5	Empowering others to act on visions
Step 6	Planning for and creating short term wins
Step 7	Consolidating improvements and producing still more change
Step 8	Institutionalising new approaches

Source: Kotter, 1995.

These eight steps in may not necessarily lead to a successful transformation. It is important to ensure that the people responsible for change must accept all the benefits and the costs of change (Strebel, 1997). People who perceive that the changes and transformation to threaten their interests and positions will do everything in their power to block and derail the change process. In the case of the transformation of the development banks in South Africa the four essential groups to buy into the process of change will be the clients of these institutions, the political establishment, the employees and their trade unions and the management of the banks. This translates to the fourth important issue in transformation, namely the politics of the change process. Stakeholders can be classified in terms of the strength of their response to change and their attitude to change. It can be a strong reaction but positive, thereby assisting the transformation. If it is a weak response but negative, it can be managed. But a strong negative reaction can be severely damaging to the change process.

Table 2: Assessing the transformation processes in the provincial development banks

Issues	Ithala	Eastern Cape banks	Agribank
Question of intervention	Yes	Yes	Yes
Application of "rules" of the new approach	Yes	Yes	No
Management of the process	Yes	No	No
Politics of the change process	Yes	No	No

"Yes" indicates adherence or fulfilment of the issues outlined while "No" indicates non-adherence

In measuring the transformation processes of the banks in the three provinces against these four issues (rules) several lessons emerge (see table 2). It is clear that the four rules were not applied equally in the different processes. This resulted in different outcomes with respect to self-sustainability and outreach for the different institutions, and in the case of the Agribank of the North West province the transformation process faltered completely. Ithala in KwaZulu-Natal province succeeded in fulfilling all the criteria stated. This resulted in a smooth and focused transformation process, supported by the stakeholders. In the Eastern Cape the process also faltered, not due to political interference but more due to a lack of dedicated political support. The before (1995) and after transformation (1998) results of the institutions underscore the impact of the different levels of success on the viability and development reach of these institutions (see Figure 1). Note that the Eastern Cape banks are treated as one entitity in the restructuring process.

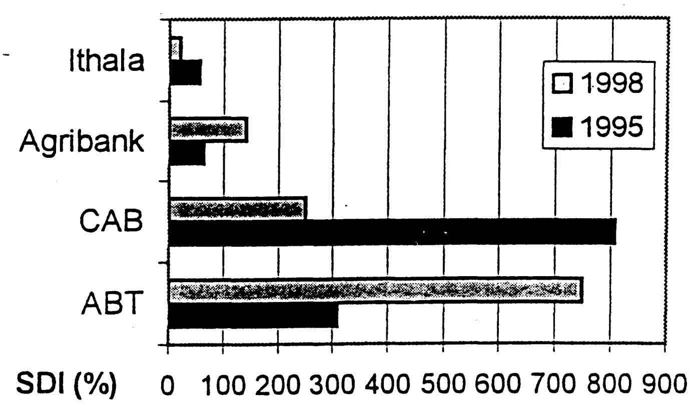

Figure 1: Subsidy Dependence Index[2] measurements for provincial development banks in South Africa, 1995 to 1998 (note the 1998 measure for Agribank is an estimate)

Conclusions

The reality of the absence of private sector retail financial institutions in rural areas, compared to urban areas, necessitate the application of a broad range of institutions and also a re-examination of the role of agricultural development banks. This, however, implies development banks in a different guise and namely the need for restructuring with the economic rationale and

[2] The SDI has been developed by Jacob Yaron (1992). It measures all subsidies flowing to a DFI and compares the subsidy flow with the ability of the DFI to generate its own income, thus a measure of self-sufficiency.

principles of restructuring clearly spelled out. Though necessary, this is not sufficient. The process of transformation must be managed efficiently along with the political dimensions of transformation. This relates to the impact of transformation on the different stakeholders in these institutions. Experience in South Africa indicates that over and above the four critical rules or questions, the process must have a clear vision of the eventual outcome and all stakeholders must share this. Specifically with respect to the political leaders the process will not succeed without the political will to go through with the transformation. The financial indicators in figure 1 clearly indicate the success story in Ithala when these aspects have been adequately addressed in the transformation process and the failure in the remaining institutions when they are not.

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